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Approved For Release 2006/04/19 : CIA-RDP85T00875R001700040021-3

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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

International Finance Series

The European Community's "Snake in the Tunnel"

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ER IM 72-138
September 1972

Copy No. 95

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
September 1972

INTELLIGENCE MEMORANDUM

THE EUROPEAN COMMUNITY'S "SNAKE IN THE TUNNEL"

Summary and Conclusions

A. In an effort to reduce the role of the dollar within the European Community (EC) and strengthen EC ties, EC members agreed in March 1972 to reduce the maximum deviation between EC currencies from 4.5% to 2.25%. Unlike the procedures for central bank intervention to support the exchange rate limits under the Smithsonian agreement (the tunnel), which involves only purchase and sale of dollars, the EC exchange rate limits (the snake) are maintained through transactions in EC currencies. One of the objects of this agreement was to end the dollar's advantage derived from its use as an intervention currency. The EC governments also hoped that the new narrow band would reduce the impact of currency disturbances on intra-regional trade relations and the operation of the Common Agricultural Policy (CAP).

B. The system operated smoothly when initially implemented on 24 April 1972, and no EC central bank intervention was necessary to maintain the EC's 2.25% band until rumors of a possible sterling devaluation in June 1972 led to a large speculative outflow from London. Despite heavy central bank intervention by the United Kingdom, Germany, and France in the period 15-22 June, the British were forced to float the pound unilaterally on 23 June. The Italian lira then became the weak EC currency, and Rome wished to withdraw from the scheme also. After considerable intra-EC discussions, it was decided to maintain the 2.25% band, but Italy was granted an exception to the provision requiring that intervention obligations be repayed in the same proportion as a country's reserves.

C. The pound crisis reinforced the feeling of critics that the EC band could be maintained only in a calm market and that exchange crises are probably magnified by the scheme. With narrower bands, weak currency

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

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countries are probably more inclined to bow to market pressures by devaluing or floating because the potential gain for speculators is increased, the flexibility central banks have before intervention is required is reduced, and intervention obligations have to be repayed in the same proportion as the weak currency country's reserves.

Introduction

1. In March 1972 the finance ministers of the European Community (EC) agreed to intervene in EC foreign exchange markets in order to keep the dollar rates of their currencies within 2.25% of one another. This compares with a 4.5% spread allowed by the December Smithsonian agreement. The EC sees this action as a first step toward monetary integration. This memorandum examines the agreement, describes the system's operation, and considers the implications of the narrow band for the international monetary system.

Discussion

2. The EC's growing economic interdependence has increased the need for Community-wide coordination of exchange rate and incomes policies. With the elimination of intra-EC tariffs and the implementation of the Common Agricultural Policy (CAP), changes in exchange rates and in national economic policies have a more pronounced effect both on members' trade balances and on the distribution of CAP costs and benefits. The 1968 exchange crisis and the subsequent franc devaluation and deutsche mark appreciation had a much greater impact on trade flows between France and Germany than on French and German trade flows generally. Moreover, Paris and Bonn felt compelled, because of the parity realignment, to introduce special border taxes and subsidies for agricultural products so that the prices politically powerful German farmers received would not fall in domestic currency terms, and the prices that French farmers received would not rise and further fuel French inflation.

3. At the Hague summit meeting in December 1969 it was agreed in principle that the EC should become a monetary and economic union. The decision on the specific form that this union would take was delayed, however, by a basic disagreement between France and Germany over the priority to be given monetary as opposed to economic union. Underlying this were differences over the extent to which national economic policy would be subject to review or coordination by Community institutions.

4. The "monetarists" and "economists" finally compromised and in October 1970 agreed to a second Werner Plan (named for the Luxembourg delegate) providing for complete monetary and economic union by 1980. The compromise, however, spelled out only the first stage of implementation. During the three-year first phase the maximum deviation among EC currencies relative to their par value with the dollar was to be reduced from 1.5% to 1.2%. The maximum swing would consequently be

reduced from 3% to 2.4%.* The need for economic coordination was also explicitly recognized and the scheme would terminate if concrete progress toward economic union was not evident by 1975.

5. The currency crisis which began in early May 1971 prevented the EC from implementing the narrower bands on 15 June, as originally intended. In the face of extremely heavy speculative capital inflows, West German authorities unilaterally closed their foreign exchange market on 5 May and the Bundesbank withdrew its support for the dollar. Although the EC Council on 9 May authorized the actions already taken by Bonn and the subsequent currency floats by Brussels (in respect to capital transactions) and the Hague, it was unable to agree on a program -- such as a common float against the dollar -- which would permit the Werner Plan to be implemented. With the suspension of dollar convertibility on 15 August, EC attention was directed toward reaching agreement on appropriate new parities, both within the EC and with the United States.

The Snake in the Tunnel

6. The EC believed that tangible progress toward monetary and economic union was both necessary and possible once the currency crisis had been resolved. A major provision of the December Smithsonian agreement widened a currency's permissible band of fluctuation around its central dollar rate from the previous 1.5% to 4.5% -- 2.25% above and below the new central rate -- (see Table 1). This wide band, implemented to allow currencies to better withstand speculative pressure, allowed the cross rate between any two currencies other than the dollar to vary by as much as 9%. The new 9% range of possible fluctuation between two EC currencies, the EC thought, would disturb intra-regional trade relations and further complicate CAP operations.

7. The EC members also believed that progress toward monetary and economic union would be an important political gesture that would strengthen the EC in negotiations with the United States on international monetary reform and would reduce dependence on the US dollar both as a transactions currency and as a reserve asset. In particular, the members

* Under the system then existing, any Community currency, such as the German mark, could be at its dollar ceiling (0.75% above its dollar par value), while another Community currency, such as the French franc, was at its dollar floor. In this case the deviation between the two currencies would be 1.5%. If conditions changed and their positions were reversed, the mark would fall 1.5%, relative to the dollar, and the franc would appreciate 1.5%. The total swing in the value of the mark relative to the franc, the variation in their cross rates, would thus be 3%. Under the Werner Plan the deviation among EC currencies would be limited to 1.2% and their total swing would consequently be limited to 2.4%.

Table 1

Summary of Currency Bands

	Percent
Old dollar band	1.5
Smithsonian dollar band -- the "Tunnel"	4.5
EC band -- the "Snake"	2.25
Benelux band	1.5
Inter-country currency fluctuation ranges	
Maximum Swing:	Range
Between the US dollar and any other currency	4.5
Between two currencies not participating in the EC system	9.0
Between one EC currency and another currency outside the EC	9.0
Between two EC currencies (except Belgium and the Netherlands)	4.5
Between Belgium and the Netherlands	3.0

wished to end the discrimination in favor of the dollar that resulted from the reduced exchange risk associated with dollar transactions (the fluctuation of any currency relative to the dollar was limited to 4.5%) and from the dollar's use as an intervention currency.

8. In March 1972 the EC again agreed to implement the first phase of a revised Werner Plan by limiting the maximum deviation between any two EC currencies, initially to 2.25%, and eventually to perhaps 1.5%. The maximum swing between any two EC currencies was consequently reduced from 9% to 4.5%, or to the same swing permitted between any EC currency and the dollar. Provision was also made for discussions on short-term economic policy coordination and for a possible Community support fund. The fund would be a partial pooling of Central Bank reserves for the

purpose, in part, of supporting EC currencies within the EC. The plan went into effect on 24 April. Apparently reassured by the prevailing calm in the exchange markets, the United Kingdom, Ireland, and Denmark joined the scheme effective 2 May while Norway, the remaining EC applicant, joined on 23 May.

9. Under the March agreement, EC central banks are committed to maintain both the 4.5% Smithsonian band -- the "tunnel" -- and the EC band -- the "snake." The Benelux countries, in a special arrangement, agreed to maintain a narrower 1.5% band (sometimes called the "worm") for their currencies.

10. The mechanics of intervention to support the EC agreement (the snake) differ from those to support the Smithsonian commitment (the tunnel). When an EC currency is at the floor of the Smithsonian tunnel, the central bank sells dollars or other reserve assets in exchange for its own currency; when it is at the ceiling, the bank uses its own currency to purchase dollars. But when intervention is required to keep EC currencies within the 2.25% band, only the countries with the strongest and weakest currencies enter the market, and they do so in EC currencies, not in dollars. The EC country or countries whose currency is at the floor of the EC band, or snake, sells the strong EC currency (which may have been acquired by drawing on interbank swap lines) in exchange for its own currency; the Community's strong country or countries uses its currency to purchase the weak currency. Intervention thus takes place only in the strongest and weakest EC currencies; dollars are not used in intervention.

11. In time of crisis, EC central banks are in constant contact through a special "hot line." Intervention, however, is automatic. The EC central banks have no discretion and intervene in the spot market to whatever extent necessary when, and only when, the spread between any two EC currencies widens to more than 2.25%.

12. The weak currency country loses reserves regardless of how the intervention is undertaken. If it intervenes directly, there is an immediate reserve loss equal to the amount of strong currency used in the intervention, including any strong currency reserves borrowed for that purpose. If the strong currency country intervenes, the weak currency country's reserve loss is delayed until it must subsequently repurchase its currency from the strong currency country. The plan provides that repurchase and repayment of any borrowing takes place at the end of the month following the intervention. The repurchase or repayment is made in gold, dollars, EC currencies, Special Drawing Rights, etc. in the same proportion as the weak currency country's reserves. Table 2 shows the composition of the individual members' reserves as of June 1972.

Table 2

Composition of Reserves of EC Members and Applicants as of June 1972

Million US $

Country	Gold	SDRs	Reserve Position in IMF	Foreign Exchange	Total
Belgium-Luxembourg	1,682	519	555	1,088	3,844
Denmark a/	69	78	71	574	792
France	3,826	573	457	4,543	9,399
Germany	4,437	691	1,046	16,455	22,629
Ireland a/	17	43	38	941	1,039
Italy	3,131	371	350	2,579	6,431
Netherlands	2,079	705	596	1,008	4,388
Norway a/	36	87	67	1,099	1,289
United Kingdom a/ b/	816	1,000	760	5,258	7,834

a. Community applicant.
b. Data are for March 1972.

Experience

13. From 24 April until the pound crisis in June 1972, no EC central bank intervention was required to introduce or maintain the EC's 2.25% band. Because of a general mistrust of the dollar, all the EC currencies were grouped in the upper region of the dollar band (see the chart). For the first month of operation the French commercial franc* was at the top of both the snake and the tunnel and the Italian lira was at the bottom of the snake, hovering around its dollar central rate. In May the Belgian

* The French (as well as the Belgians) continued to maintain their two-tier system with separate markets for trade and financial transactions. The financial franc was trading at more than a 5% premium, relative to its dollar central rate.

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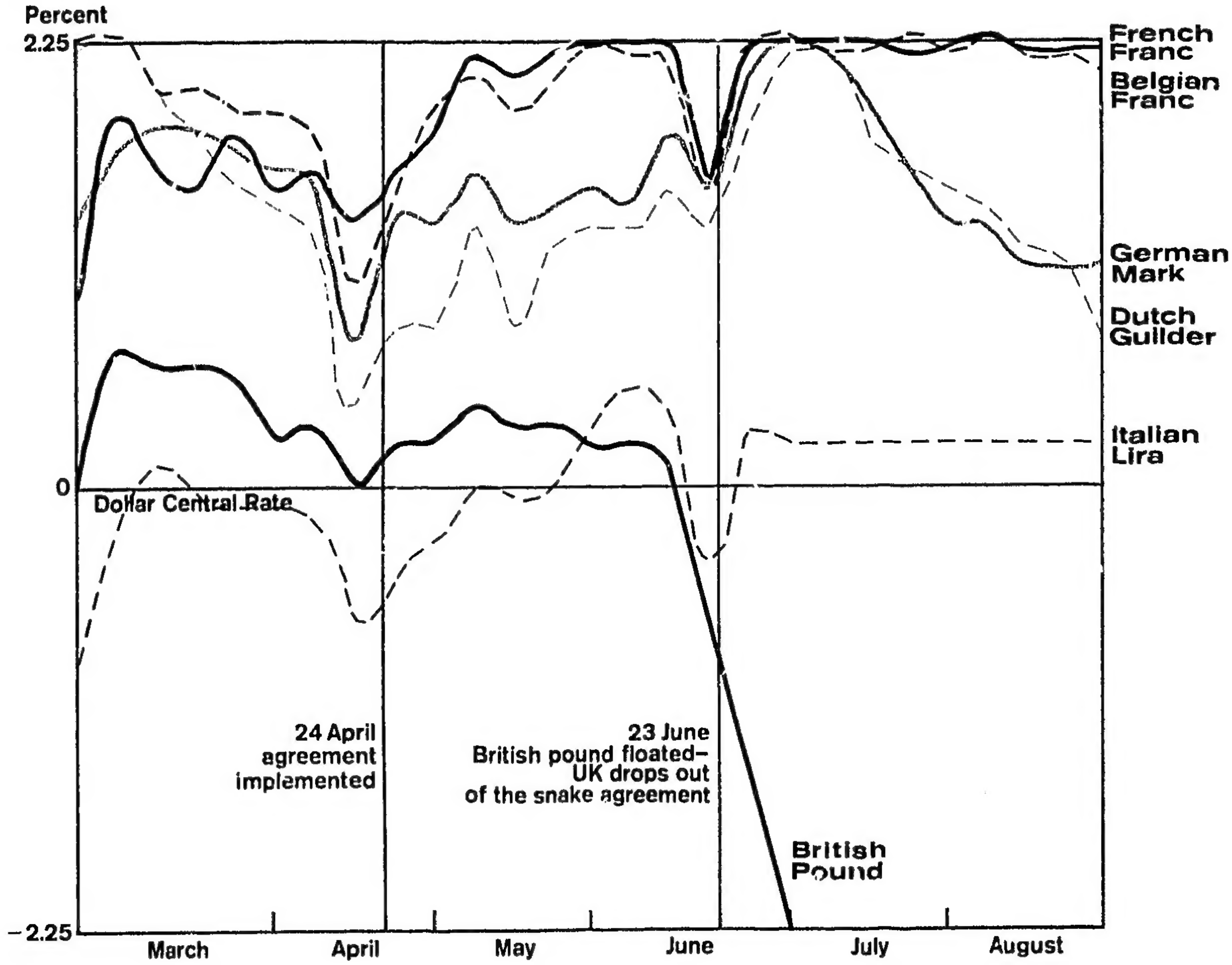

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franc moved to the top of both the EC and dollar bands, and the pound replaced the lira at the bottom of the EC band, as the inflow of tourist dollars into Italy buoyed that currency. Although no intervention was necessary to maintain the EC's 2.25% band, the French did intervene in May to prevent the franc from rising more than 2.25% above its dollar central rate.

14. The first test of the Werner Plan came in mid-June, when rumors of a possible sterling devaluation led to a large speculative capital outflow from London. On 15 June, sterling fell below its dollar central rate, and, with the French franc at its dollar ceiling, intervention was required to maintain the EC's band. Because EC rules call for intervention only in EC foreign exchange markets, the spread between sterling and the franc actually exceeded the 2.25% band on 15 June in subsequent trading in New York. In the period from 15 June to 22 June, about US $2.5 billion in sterling are believed to have been purchased by the Bank of England and EC central banks in an unsuccessful effort to maintain the 2.25% band. The Germans are believed to have taken in about $1 billion, and the French about $500 million. Finally, on 23 June, the British unilaterally floated the pound.

15. Following the pound float and the withdrawal of Denmark and Ireland from the arrangement, the Italian lira was the weakest EC currency and came under heavy speculative pressure. Rome wished to withdraw from the scheme, but after considerable intra-EC discussion it was decided to maintain the EC's 2.25% band. However, the Italians were allowed to repay their intervention obligations in dollars. This proved to be a minor concession, as total intervention on behalf of the lira is believed to have been less than $200 million. By August, both Rome and London had repaid their intervention obligations.

16. Only modest additional central bank intervention has been required since the pound float to maintain the EC's 2.25% band. Substantial intervention has been required, however, particularly in the period immediately after the pound float, to prevent EC currencies from rising more than 2.25% above their dollar central rates. The Belgians have also recently been forced to intervene to maintain the 1.5% band for the Benelux currencies.

Implications and Problems

17. The pound crisis reinforced the feeling of critics that the EC band could be maintained only in a calm market. Although the pound was not believed to be substantially overvalued, comparatively heavy intervention was nevertheless required and the pound was eventually forced to float. Three members (the United Kingdom, Denmark, and Ireland) dropped out

of the arrangement as a consequence of the crisis, and a major modification was required to prevent Italy from withdrawing also.

18. Exchange crises are probably magnified by the EC's narrow band. In the absence of the narrow band, speculators stand to gain only from the change in the weak currency's exchange rate relative to the dollar – the intervention currency. Under the EC's currency agreement, however, the speculator stands to gain from both a weak currency's devaluation relative to the dollar and from the subsequent appreciation of other EC currencies relative to the dollar. In the pound crisis, for example, the pound, once freed from its central rate, depreciated 3.7% relative to the dollar in the period 23-28 June, while the French and Belgian francs, now freed from the depressing influence of the pound, appreciated 1.3% relative to the dollar. Speculators consequently stood to gain 5.0% rather than 3.7%.

19. The agreement probably makes the governments of weak currency countries more inclined to bow to exchange market pressures by devaluing or floating. Because of the EC's 2.25% band, the weak currency country is unable to take full advantage of the wider dollar band when another EC currency is above its dollar central rate. In the pound crisis, for example, the strength of the other currencies participating in the monetary agreement reduced the Bank of England's potential cushion by eliminating an additional 2% in possible downward exchange rate adjustment before central bank intervention was required.

20. The need to repay intervention obligations in the same proportion as the weak currency country's reserves, including gold and SDRs, probably further inhibits a country from defending its exchange rate. As demonstrated by the exception that Italy was granted after the sterling float, the proportionality feature is quite unattractive to the debtor countries under present conditions of dollar glut. The obligation to use gold in repayment has also increased the pressures to increase the price of gold, at least for monetary transactions within the EC, with the official gold price, $38 per ounce, far below the free market price. The French have suggested that gold be valued at $70 per ounce for intra-EC official settlements, but this was not supported by the other EC members.

21. Strengthening the currency agreement in order to effectively deter speculation will probably require both an increase in the amount of reserves available for EC intervention and increased capital controls. Existing EC inter-bank "swap lines" and standby credits are believed to total about $3.5 billion. Individual members' holdings of other EC currencies are relatively small. These "swap lines" and holdings are likely to prove inadequate, without additional controls on intra-EC capital movements, if the realism of a particular EC exchange rate comes into serious question.

Prospects

22. The future of the EC currency agreement is unclear. Its political importance probably assures its continued existence in some form, but not its success. The scheme failed to weather its first test intact, and the exception granted to Italy has been prolonged and may be extended to other countries, in part, to facilitate UK reentry into the arrangement. Despite these early difficulties, the members are nevertheless considering narrowing the EC band further, perhaps to 1.5%.

23. The EC is likely to try to strengthen the currency arrangement at the EC Council meeting at the end of October. The Council is expected to ratify at that time the recent agreement in principle to establish a European monetary cooperation fund. Managed by the Central Bank Governors' Committee under the general supervision of the Council, the fund will coordinate EC central bank intervention to maintain the 2.25% band as well as provide short-term foreign exchange credits. The agreement also provides for a broader use of a European unit of account, a proxy for the dollar now used exclusively under the CAP. Although the agreement makes it appear that the EC is ahead of the schedule suggested in the Werner Plan, it will not significantly change the existing system.